MORTGAGE BANKING

MARCH 1986

A450-2

5219 SU
SRI ACQUISTIONS
CONGRESSIONAL INFORMATION
SERVICE
4520 EAST-WEST HGWY, SITE 200
BETHESDA, MD 20814

MORTGAGE BANKING

VOLUME 46 NO. 6
MARCH 1986

ARTICLES

PAGE 8
ARMs: STILL A BOUNTIFUL CATCH
Thomas S. LaMalfa and Jon G. Holm
Adjustable rate mortgages are no longer unknown or questionable commodities in the eyes of the borrower. This article encourages mortgage bankers to remain interested in ARMs because there is both an investor market and consumer interest in them. MGIC's experience with ARMs provides sellers with substantive information about what features investors are looking for.

PAGE 18
WHAT'S NEW AT THE BOARD OF TRADE?
Thomas Thompson
Cash settled GNMA futures will begin trading at the CBOT this May. This futures contract sidesteps all the issues and complications associated with deliveries of GNMAs certificates or CDRs. According to the author of this article, all the usual worries about timing, invoicing and ascertaining what security is cheapest to deliver do not arise.

PAGE 19
STRATEGIC PIPELINE HEDGING: COST EFFECTIVE APPROACH
Stephen R. Rigsbee and Sirri Ayaydin
This article explains how mortgage lenders can hedge mortgage pipeline risk using Treasury bond futures and futures options. The efficient and liquid markets for these instruments should motivate mortgage lenders to use them in their pipeline hedging programs.

PAGE 34
CMOs: GUARANTEED DELIVERY
Les Parker
All the factors involved in establishing and running a CMO program are detailed in this article. CMOs deliver mortgage products to the capital market. Keeping in mind the risks involved with running a CMO program, lenders can be well compensated for their efforts.

PAGE 44
FREDDIE MAC PCs: ANALYZING COMPETING POOLS
Susan D. Mara
Evaluating generic Freddie Mac trades is complicated by the fact that it is difficult to identify the average characteristics of a Freddie Mac participation certificate. It is not possible to identify a "generic" Freddie Mac security. Any analysis of Freddie Mac PCs should recognize these securities and value them accordingly.

PAGE 59
FOLLOWING THE NEW FANNIE MAE GUIDELINES
Judith Dedmon
An entirely new set of Fannie Mae lender guides will be issued this month. The reasoning behind these changes and its effect on 2,000 lenders are explained in this article.

PAGE 67
ACCRETION BONDS: SALIENT FACTORS
Kurt van Kuller
This article serves as a guide to investors on the factors affecting redemptions and some of the causes of early redemption.

PAGE 85
SPLIT FEE OPTION: INCREASED LEVERAGE AND DECREASED RISK
Richard M. Kaplan, Douglas R. Hiscano, Ernst J. Mikosch and David Weiner
An explanation of the many advantages of the split fee option over the conventional option is provided in this analysis. The split fee option provides an opportunity for the investor to save money in an unfriendly market.

PAGE 89
WHAT THE PRESIDENT'S TAX PROPOSAL MEANS TO REAL ESTATE
Michael S. Salkin and Michael Smith-Heimer
Key provisions on how the President's tax proposal will affect real estate are outlined. The areas addressed are the cost of homeownership, effects on investment properties and property values.

PAGE 97
THE LAST WORD (CALCULATING A RISK PROFILE FOR THE MORTGAGE PIPELINE)
Paul E. Tuttle, Jr.
An approach for valuing a mortgage pipeline of commitments is developed in this article.

DEPARTMENTS

ABOUT THE ISSUE	5
PEOPLE	102
BOOKS	106
SECONDARY MORTGAGE MARKETS	111
MORTGAGE MARKET TRENDS	113
AD INDEX	126

SALIENT FACTORS

The terms "compound interest bonds" or "accretion bonds" refer to all securities in which interest payments are not paid on a current basis to bondholders, but are deferred and reinvested at a compounded rate by the issuer or are substituted for by an accretion of principal at a compounded rate. The Treasury Department treats both cases similarly, defining them as imputed interest. It includes such variations as zero coupons, capital appreciation bonds, some original issue discount bonds and compound coupon bonds. This year, hybrids have been developed which convert to current interest bonds at some future date.

The overwhelming majority of municipal accretion bonds have occurred in housing issues. A special study conducted by Securities Data Company, Inc. (see Exhibits A-D) shows that, in 1984, 85 percent of total accretion bond dollar volume and 77 percent of the total number of issues containing accretion bonds were housing bonds. In 1982, the year of the first modern zero coupon bond (Massachusetts Transportation Authority), those numbers were 78 percent and 86 percent, respectively. Through the first six months of 1985, the housing predominance continued, at 75 percent and 81 percent, respectively. The new convertible issues, not included in the aforementioned 1985 figures, follow the same pattern with 72 percent of their total dollar volume in housing bonds. They also occur much more in single-family than multi-family issues (82 percent of housing accretion bonds in 1984 were single-family issues).

Accretion bonds are ideally suited for housing issues. Internal Revenue Service rules concerning "original issue discounts" make competitive sales of issues containing accretion bonds prohibitively difficult, favoring negotiated sales. The convertible hybrids are especially useful in avoiding the federally imposed debt limitations on annual housing bond volume. Compound interest bonds also offer flexibility in managing outstanding mortgage portfolios in which prepayment irregularities have cropped up by smoothing out debt service. Private developers benefit if they do not have to finance bond discounts. Additionally, mortgage rates can be lowered because accretion bonds are priced at slightly lower yields than comparable term bonds to account for the compounding.

The main advantage of all compound interest bonds is the reduction of total borrowing cost to the issuer. The total interest paid is often mistaken as greater than in current interest bonds due to the compounding effect, but that is more than offset by paying in cheaper future dollars. Furthermore, a properly structured issue will result in a reallocation of the majority of the bond principal from the end of the maturity schedule to the early years. This results in a much more rapid bond amortization and a dramatic reduction in interest payments. This effect is greatest with higher interest rates and rising yield curves. When this effect is efficiently coupled with single-family prepayment redemptions of principal, the results are magnified.

For investors, the main advantage of compound interest bonds, of course, is the reinvestment and compounding of interest at the desirable fixed-rate of the time of purchase. Current interest bond yields (as well as on C.D.s or money market funds) are determined assuming interest is reinvested continually at the initial rate. However, this is, in reality, virtually impossible. It also does not account for managing time and transaction expenses of perennially processing and reinvesting coupons. For this benefit, the investor in accretion bonds sacrifices current income. In addition, at the time of this writing, the supply of compound interest bonds is somewhat heavy, creating undervalued situations. For bond portfolios, such as unit trusts, accretion bonds may be used to lower average prices without disproportionately reducing current return.

Deep discount bonds are also more subject to greater percentage price swings during interest rate shifts.

continued

Kurt van Kuller

Conversely, however, the same changes are much less in absolute dollars than in current interest bonds. The zero coupon market is, however, relatively less volatile because it is more sophisticated.

The major surprise to investors is premature redemptions. This can be dangerous if a premium was paid for the bonds. There is no special redemption risk generic to accretion bonds. Their redemption frequency is no different from other current interest bonds. Housing bonds, however, have experienced many redemptions. The damage from a compound interest bond redemption may be considered greater (on a percentage basis) if it was originally purchased at a price above redemption value plus redemption premium, if any. Therefore, investors in compound interest bonds must beware of housing bond redemptions because accretion bonds are a housing bond phenomenon.

Housing bond redemptions

Tax-exempt housing bonds are subject to several generic types of special redemptions which other types of municipal bonds do not experience. This is due to the nature of the underlying security mortgages. Conversely, tax-exempt mortgage revenue bonds are for the most part protected by federal laws, such as the Mortgage Subsidy Bond Tax Act of 1980 and Section 11(b) of the Housing Act of 1937 from the most prevalent form of extraordinary redemption of municipal bonds—refunding issues. Most housing bonds also have very limited optional redemption features which are rarely utilized. Term maturities in all municipal bonds are usually subject to normal mandatory sinking fund redemptions, of course.

A discussion is necessary to describe the kinds of redemptions possible with both single- and multifamily housing bonds, the associated risks and ways in which these risks are detected and mitigated. Bonds called in these manners are usually always at par or at their compound accreted value, if applicable. Investors suffer a premature return of principal and loss of any premium paid for the bonds above par (or gain of any discount from par). The windfalls achieved by bondholders of other kinds of issues through refundings at premium and advance refundings are, for the most part, not present.

"The main advantage of all compound interest bonds is the reduction of total borrowing cost to the issuer."

Single-family mortgage revenue bonds

Nonorigination redemption: This is far and away the main source of concern among investors. Unexpended proceeds remaining in mortgage acquisition funds must be called after the expiration of the origination period. The reasons for nondelivery, the failure of participating originators (banks, mortgage bankers, and/or the issuing housing authority) to acquire mortgages, are generally superior competition and lack of demand. The vast majority of these redemptions occurred in bonds issued from the last quarter of mid-1981 to Fall 1982, when interest rates reached historic highs. Mortgage rates subsequently dropped 300 basis points in the latter part of 1982. Bonds from this period were locked into offering uncompetitive mortgage rates and consequently, large portions of many of these issues were redeemed throughout the next few years.

This potential for nonorigination always exists if there is a precipitous decline in mortgage rates during the origination period. A substantial partial redemption may produce the unexpected new credit risk of a very small outstanding mortgage portfolio. This may create a lack of geographic dispersion and nonconformity to normal statistical patterns for mortgage defaults and prepayments and an inability to meet fixed expenses (such as those of the servicer, trustee and administrator).

continued

EXHIBIT A

1984 Accretion Issues

PROJECT TYPE	TOTAL ($ millions)	PERCENT OF TOTAL $ VOLUME	# OF ISSUES
Airport Facilities	4.155	0.074	1
Educational Facilities	264.942	4.739	14
Hospital Type Unknown	7.780	0.139	1
Hospital General Acute Care	56.000	1.003	4
Industrial Development	16.900	0.301	1
Single Family Housing	4,875.650	69.328	154
Multifamily Housing	857.713	15.343	85
Transportation	37.875	0.678	2
Electric Power Facilities	21.639	0.387	6
Water, Sewer & Gas Facilities	160.735	2.875	20
Other	286.965	5.133	23
TOTAL DOLLAR VOLUME	$5,590,320	100%	311

Kurt van Kuller is vice president and director of municipal research for Moseley, Hallgarten, Estabrook & Weeden Inc. in New York City. Prior to joining the firm, van Kuller was a senior officer in the housing group for Standard and Poor's Corp., where he did analysis and assignment of ratings on municipal housing bonds.

EXHIBIT B

1985 1st Half Accretion Issues Proceeds Totals

PROJECT TYPE	TOTAL (in millions)	PERCENT OF TOTAL $ VOLUME	# OF ISSUES
Housing Type Unknown	3.868	0.119	1
Educational Facilities	85.982	2.644	10
Hospital General Acute Care	85.331	2.624	4
Single Family Housing	1,565.815	48.157	80
Multifamily Housing	874.105	26.883	78
Waterfront/Seaport Facilities	4.061	0.125	1
Transportation	246.717	7.588	3
Electric Power Facilities	171.199	5.265	4
Water, Sewer & Gas Facilities	102.158	3.142	6
Economic Development	0.850	0.026	1
Other	111.389	3.426	6
TOTAL DOLLAR VOLUME	$3,251.475	100%	194

The number of issues does not necessarily equal the sum of the number of issues listed because of composite offerings.

EXHIBIT C

1982 Accretion Issues Proceeds Totals

PROJECT TYPE	TOTAL (in millions)	PERCENT OF TOTAL $ VOLUME	# OF ISSUES
Educational Facilities	73.480	2.498	3
Hospital General Acute Care	349.640	11.892	8
Nursing Home & Life Care Facilities	32.930	1.120	1
Student Loan Programs	13.050	0.444	1
Single Family Housing	1,483.173	50.446	45
Multifamily Housing	813.636	27.673	62
Transportation	68.270	2.322	2
Water, Sewer & Gas Facilities	105.985	3.605	3
TOTAL DOLLAR VOLUME	$2,940.134	100%	125

The number of issues does not necessarily equal the sum of the number of issues listed because of composite offerings.

EXHIBIT D

1985 1st Half—Convertible Issues (Gains, Stairs, Etc.) Proceeds Totals

PROJECT TYPE	TOTAL (in millions)	PERCENT OF TOTAL $ VOLUME	# OF ISSUES
Educational Facilities	32.874	5.021	1
Hospital General Acute Care	29.162	4.454	3
Single Family Housing	392.177	59.897	13
Multifamily Housing	78.582	12.002	5
Transportation	72.112	11.014	2
Electric Power Facilities	49.847	7.613	2
TOTAL DOLLAR VOLUME	$ 654.754	100%	26

The number of issues does not necessarily equal the sum of the number of issues listed because of composite offerings.

The length of the origination period, varying between indentures, issuers and states, usually ranges from six months to three years.[1] During this time, the undisbursed mortgage money remains in securities or in an investment agreement designed to at least meet debt service and issue expenses. Occasionally, extension provisions are present in indentures, but a new investment agreement or additional money from outside sources often would be required to pay bond expenses for the extended time due to interest rate changes. Large housing authorities with capable staffs often have at their discretion the flexibility to redeem bonds from unused proceeds on several different dates within the origination period.

Restrictions on disbursements: These have a significant impact. A fixed draw schedule, due to the nature of the acquisition fund investments, may be in place. Quite common is the allocation of monies between originators, some of whom may not meet their anticipated goal. Their past experience should be examined by investors. More restrictive are builder reservations, common in California, in which the funds are tied to sales at specific developments. Reallocation to successful originators or a change to a "first come—first serve" basis after some interval reduces redemption risks. Nonrefundable commitment fees may provide servicers with extra incentive and provide necessary funds for nondelivery redemptions. Lifting of restrictions to geographic areas (such as counties, cities or certain Census tracts) is also a positive.

Between 20 percent-40 percent of each SFMRB (single-family mortgage revenue bond) must be delegated to low-income HUD-approved targets areas for one year, if any exist. Often, issuers may impose further area restrictions to benefit depressed sectors. Federal requirements have also greatly increased the administrative processing time for underwriting mortgages from tax-exempt bonds.

Demand: Projections must isolate the first-time homebuyer market and determine the capture ratio of the total estimated market that the issue is attempting to attain. Federal law limits 90 percent of the acquisition fund purchases to mortgagors who have

had no ownership interest in a principal residence during the prior three years except in targeted areas. Purchase prices are also capped at 110 percent of average area prices (120 percent in targeted areas). Issuers often impose additional underwriting standards and income limits which can decrease the pool of mortgagors.

The types of mortgages offered (i.e., GEMs, ARMs, rehabs, home improvement loans, construction financing), the downpayment provisions and total points charged also affect their attractiveness. Limits on types of homes to be financed (townhouses, developments, condos, co-ops, two- to four-units, mobile homes, etc.) are often incorporated. Demand studies, by recognized consulting firms, should be carefully studied for underlying assumptions. Local housing conditions such as conditions of housing stock, conversion, vacancy rates, etc., should be considered. New housing construction below price limitations is important to meet first-time home buyer demand. Some issues have limited the amount of mortgages on existing homes versus new construction.

The economy of the region, cyclical and diverse in demographics, should be examined. Unforeseen local events such as flooding, moratoriums on water or sewer connections, bank closings, etc., may hamper originations. Current and future competition from other financing sources, including other tax-exempt bonds in adjacent areas, FHA and VA rates may have an impact on delivery. Comparisons should consider other factors such as downpayments, buydowns, subsidies and points, as well as rates. The track record of past issues in the area can be a useful demand indicator. The level of requests by originators and subsequent commitments for mortgage money is an important yardstick.

Mitigating factors: During the origination period, if full delivery appears doubtful due to a sharp interest rate decline, it may be possible to meld the issue with proceeds of a new cheaper one or with other external funds. State agency issuers are more likely to have this capability to lessen redemption risk as well as having wider geographic dispersion of mortgages. Dilution of the credit strength of the outstanding bonds is a concern of an open lien, which must be weighed against the benefits of a seasoned portfolio. Housing authorities with ongoing programs and sizeable staffs, however, would usually prefer any alternative to a major nonorigination redemption. Limits on annual housing bond volume may, of course, hinder this technique. Bondholder approval may be necessary for additional bonds or modification of underwriting standards. Issues may achieve slightly lower expected rates by opting to credit mortgagors any excess arbitrage earnings, rather than sending such funds to the United States Treasury. Rare issues that are structured assuming prepayments to meet debt service or those with mortgage forgiveness can produce slightly lower mortgage rates.

"For investors, the main advantage of compound interest bonds, of course, is the reinvestment and compounding of interest at the desirable fixed-rate of the time of purchase."

Prepayment redemptions: Premature recoveries of mortgage principal are usually caused by mortgagor refinancings, partial prepayments, foreclosures, mortgage insurance collections and property damage insurance proceeds. The broad areas are often lumped together and significantly reduce the life of a bond issue. It should be noted that prepayments may affect the cash flow coverage and surplus levels of individual bond issues positively or negatively, due to priority calls and interest rate structures.

Factors affecting prepayments: One main determinant of a mortgagor's intentional prepayment is the attractiveness of the mortgage. Many of the bonds sold during the highest interest rate periods, after possibly experiencing large nonorigination calls, are now faced with rapid prepayments because of the onerous underlying mortgage rates. Assumability of mortgages in the portfolio is also a major factor. Other legal restrictions may be in place. Prepayment penalties during the early years of a mortgage can have some impact.

Other influences are income levels, mortgagor age and upward mobility, general economic conditions, social and demographic trends, the local housing supply and appreciation rates and major employer dislocations. A mortgage forgiveness program (cancelling remaining mortgage debts after all bonds are retired) may encourage mortgagors to hold out longer. Foreclosure laws and mortgage insurance policies will influence whether defaulted mortgages are paid off in full or assumed by insurance companies.

Prepayment statistics on various types of mortgages have been shown to vary significantly between geographic regions. Generally, southern states such as Texas, Arkansas, the Carolinas, Virginia and Georgia experienced some of the fastest rates in the nation in recent years, although Louisiana, Florida and Oklahoma were at national averages. Certain Midwestern states such as Missouri, Kansas, Illinois and Nebraska were also among the highest, while Michigan was low. Among those with the slowest rates in the nation were Washington, Oregon, Arizona and New York. Puerto Rico was even slower.[2] However, these results may change radically over short time periods and by comparisons of different kinds of mortgages. Dramatic differences between cities and counties also occur.

Predicting prepayments: There is no foolproof methodology for forecasting prepayments on mortgages purchased by tax-exempt, single-family mortgage revenue bonds. Not only is there an insufficient historic record and no central information gathering source, but swings in prepayment patterns have been detected in recent

continued

years for all home mortgages. Cash flow projections required by rating agencies have utilized FHA experience (see Exhibits 1 and 2) with some much older issues run on a GNMA (12-year average life) index.

The 1980 Ullman bill mandates a 100 percent local FHA experience run to estimate arbitrage earnings. FHA mortgagors are similar perhaps in income levels, but are not necessarily first-time homebuyers subject to prepayment penalties and subsidized by tax-exempt rates. FHA loans are assumable and have lower downpayment requirements. The FHA index, although it accounts for the age of loans, has certain drawbacks. It does not adequately address different coupon rates in various market scenarios and it has been updated almost annually with some substantial revisions.[3] Only 15 of the 30 years of data are actual. The rest is estimated.[4] Furthermore, FHA statistics do not give information on partial prepayments and their dollar value. Cancellation of FHA insurance policies, other than defaults or total prepayments, may also slightly skew the index.

A few municipal issues have provisions to sell off remaining mortgages and redeem bonds when the portfolio reaches a very small level. Rating agency requirements of zero prepayment runs and extremely rapid three-year average life tests give the investor some comfort. Perhaps the newly developed PSA standard prepayment model would be an improvement because it smooths over disjointed annual shifts in FHA prepayments. If possible, investors are recommended to examine the experience of past bonds of the issuer or similar ones.

Recycling: Many issuers have the flexibility within bond indentures to reuse recoveries of principal to purchase additional mortgages which meet program guidelines rather than redeem bonds. This may, in some cases, effectively bypass prepayment redemption risk for investors. Rating agencies view the practice as a negative credit characteristic mainly because of the potential for portfolio dilution. Also, the high coupon bonds experiencing the most rapid prepayments would require underwriting noncompetitive mortgages. The most effective use of this technique is made by state agencies (such as the Connecticut Housing Finance Authority) with large staffs and with other outstanding bonds from which all prepayments may be blended. The result is that new mortgages need cover only the average weighted bond interest cost. The redemption risk is thus lowered contingent upon the success of the recycling program. This activity has become more attractive to issuers since imposition of bond volume restrictions.

More solutions: Reinvestment into securities sufficient to pay debt service, if possible, would preempt redemptions. Treasury regulations, of course, severely limit this ability. Purchasing bonds on the open market is another alternative, but one that is not particularly advantageous to bondholders. That is because such activities are usually secretive and issuers would offer no premium.

Other redemptions: Surpluses from float and interest income may be treated similarly to prepayments or may revert outside the issue to the housing authority. Although considered a negative for bond ratings, an open indenture can reduce redemption frequency. Certain issues also have extra large reserves which are used to call bonds at a fixed date or periodically through reductions tied to the outstanding mortgage portfolio. Older issues were permitted to use up to 15 percent of proceeds for reserves while others were contributed from outside sources. Many indenturers also allow a

continued

EXHIBIT 1

Survivorship and Decrement Table as of December 31, 1983 for FHA-Insured (Section 203) 30-year Home Mortgages Insured since 1970

	Survivors at Beginning of Year	Terminations During Year	
		Claims	Nonclaim (Prepayments, etc.)
1	100%	707%	1.38%
2	97.9	1.965	3.71
3	92.2	1.433	4.36
4	86.4	917	4.12
5	81.4	612	4.20
6	76.6	434	4.40
7	71.8	362	4.12
8	67.3	308	4.00
9	63.0	234	3.87
10	58.9	160	2.91
11	55.8	146	2.43
12	53.3	111	2.25
13	50.9	079	2.21
14	48.6	049	2.20
15	46.3	022	2.15
16	44.2	019	2.08
17	42.1	017	2.00
18	40.0	015	1.90
19	38.1	013	1.80
20	36.3	012	1.69
21	34.6	010	1.58
22	33.0	009	1.75
23	31.3	007	1.88
24	29.4	006	1.98
25	27.4	005	2.05
26	25.3	004	2.07
27	23.3	003	2.07
28	21.2	002	2.03
29	19.2	001	2.62
30	16.5	001	16.54

EXHIBIT 2

Claims for FHA-insurance and prepayments on all single-family mortgages endorsed, by year of endorsement:

Endorsement Year	Claims Rate	Prepayment Rate
1976	3.1%	26.1%
1977	2.3	15.8
1978	2.7	7.4
1979	3.7	3.1
1980	5.1	3.8
1981	7.6	12.8
1982	2.9	12.7

total redemption toward the end of the bond's life if reserves on-hand equal or exceed liabilities. Senior lien bonds may have redemptions triggered by defaults on subordinated issues. Issues convertible from accretion bonds to current interest bonds at a future date usually are subject to an optional call at that time.

Multifamily mortgage revenue bonds

The risk of all premature redemptions of multifamily housing bonds is relatively minimal and should be differentiated sharply from SFMRBs. In fact, since refunding bonds are not allowed, multifamily issues must rank among the least likely of all municipal bonds to be called. Let us review the kinds of possible multifamily bond redemptions, recognizing the greater variety of subsidy programs and tax laws (e.g., Section 11[b] of the National Housing Act vs. Section 103[c] of the Internal Revenue Code), the presence or lack of certain insurance policies and whether the bonds are a state agency obligation or a local deal. Investors should also be cognizant of substantial differences that may exist in special and developing types of issues such as LOC-backed, insured, collateralized or "Muni-Mae" issues.

Noncompletion: In most cases, this is synonymous with minimal construction risk. Another rare possibility would be a major interest rate rise which kills project feasibility. The construction period is limited by the indenture to a reasonable fixed date, after which bonds are subject to a mandatory par call if certain conditions regarding completion have not been satisfied. The bond proceeds remain in escrow during this time, invested in U.S. Government bonds or pursuant to an investment agreement. Failure by HUD to grant "final endorsement" due to faulty construction or breach of other contractual provisions is the usual trigger for this type of redemption in FHA-insured issues. Unforeseen cost rises can usually be met by completion bonds, cash infusion from owners, fixed price contracts, performance bonds, letters-of-credit and a 10 percent retainage reserve of construction funds. Limited extensions of the construction period and even commencement of mortgage amortization are obtainable, if funds available are sufficient to meet bond debt service and other expenses.

Occasionally, construction financing is funded by bond proceeds in certain FHA-insured deals. Each advance for construction spending must be FHA-insured, so that if the project is never built, the bonds are redeemed from insurance proceeds. In other instances, uninsured Section 8 may be bonds issued after projection completion for take out of construction of other prior financings, so that the risk is nonexistent. State agencies often have incorporated the right of substitutability of projects in indentures. That enables them to transfer bond proceeds to a long list of other suitable projects in the event of noncompletion. Thus, various state agency issues bear virtually no noncompletion redemption risk. Section 103(c) of the Internal Revenue Code, however, limits the unrestricted arbitrage period for multi-

Loan Processing, Document Preparation, and Laser Printing on My Budget?

Bah, Humbug!

It's true, Ebeneezer, it's true! Don't let the Ghost of Systems Past make you believe you need a programmer every time you need a new form. Sulcus systems for Loan Processing, Closing, Servicing, and Tracking now give you the tools you need to easily produce your own documents on the computer. You can even Laserprint everything on plain paper...and it's all pinchpenny affordable.

For the little bit of Scrooge in all of us.

Call 800-245-7900 for more information.

SULCUS

Sulcus Computer Corp.
41 North Main Street
Greensburg, PA 15601

family bonds to three years, but does not mandate redemptions.

Reduction of mortgage: Quite often there is a relatively minor redemption after cost certification in "stand-alone" deals (i.e., local or an agency issue not commingled with other project financings) from unused bond proceeds. HUD will reduce the mortgage amount if the construction costs come in lower than expected, so it is necessary to redeem a corresponding amount of bonds and proportionally reduce reserves. These surpluses should not be reinvested because of arbitrage rules and long-term investment risk. Lower costs could occur due to conservative budgeting and competitive construction markets. A related development at cost certification is the determination that insured construction advances were used for ineligible costs. The mortgagor must produce these funds for redemption of a ratable amount of bonds or face a default.

FHA insurance proceeds:[5] In the event of a default, insured mortgages are assigned by the trustee to FHA in "stand-alone" deals and some state agency issues. The insurance proceeds are used to meet an acceleration of bonds. The debt service reserve in these single-project issues must not be drawn down until after the assignment to FHA. Insured local issues, which, unlike uninsured issues or many state agency issues, allow no work outs of troubled projects, therefore, have a somewhat greater chance of premature redemption as a trade-off for security of principal. A minor cure period, however, is present in some indentures so that the assignment can be halted in the event of full restitution. Section 221(d)(3) and (d)(4) programs allow HUD to grant operating loans during the first two years after project completion. Some other programs allow FHA to opt to payoff in debentures precluding redemptions.

The default rate on FHA-insured multifamily mortgages varies considerably over time according to the particular insurance program. Most municipal bonds were used in conjunction with Section 221(d)(3) and Section 221(d)(4) of the National Housing Act. The Section 221(d)(3) program for nonprofit and cooperative mortgages will insure up to 100 percent of project replacement cost of new construction. Section 221(d)(4) for private owners will insure up to 90 percent, requiring an equity contribution for the remainder. The Section 221(d)(3) projects, begun in 1954, are divided almost evenly between those made at below-market rates (BMIR) or at market, although the BMIR program has been inactive since 1972. HUD statistics[6] show that 32 percent of BMIR projects have applied for FHA insurance compared with 18 percent of market rate 221(d)(3)s. However, the 221(d)(3) market rate insurance claims decreased drastically by 1975, with none since 1977.

More than half of Section 221(d)(4) projects are subsidized. The nonsubsidized 221(d)(4) claim rate is 16 percent, but subsidized projects have a low 2 percent rate. The vast majority of all 221(d)(4) claims occurred in the 1970s. Section 223(f), which includes a coinsurance program for GNMA-collateralized bonds, has a low 3.4 percent claim rate since its inception in 1975. Some older multifamily bonds include projects under the Section 236 program, which was active from 1968 to 1973. However, not all issuers opted for the mortgage insurance as well as the deep interest rate subsidy (e.g., Massachusetts Housing Finance Agency). The claims rate on this troubled program is 18.5 percent.

Prepayments: Optional mortgage prepayments by private owners of Section 8 projects financed by tax-exempt 11(b) bonds have been very rare to date. Most of these issues, whether or not insured or collateralized, have lengthy optional call protection at significant premiums incorporated into the bond indenture as a major deterrent. Furthermore, 11(b) refunding bonds are prohibited by HUD and private sources for refinancing have not had sufficient economic justification.

However, at some point in the future, taxable rates on HUD regulations may become more amenable. Furthermore, the tax benefits for most owners of most Section 8 projects should dry up by the end of this decade. (Section 8 contracts were renewable on 5-year terms from 1974 to 1979. Since then, they have been for 20-, 30- or 40-year terms.) However, conversions to co-ops or cancellations of Section 8 contracts are unlikely to

A Loan System with Power and Growth Capacity on My Budget?

Bah, Humbug!

It's true, Ebeneezer, it's true. If the Ghost of Systems Present has scared you away from buying the computer horsepower you need, let Sulcus help. Our systems for Loan Processing, Closing, Servicing, and Tracking easily expand when your loan volume grows—without changing your software or procedures. If power and potential are important to your profitability, look at Sulcus...and it's all pinchpenny affordable.

For the little bit of Scrooge in all of us.

Call 800-245-7900 for more information.

SULCUS

Sulcus Computer Corp.
41 North Main Street
Greensburg, PA 15601

attain necessary HUD approval or overcome local laws and political obstacles. More likely would be conversions to public ownership.

It is also possible for owners to refinance bonds of this type to remove certain onerous 11(b) restrictions and still leave the Section 8 contract intact.[7] HUD's concerns center on the perpetuation of low-income elderly housing, not on the financing. In fact, a reduction of debt service, if achievable, would reduce the Section 8 subsidy payable by HUD.

Underlying tax-exempt mortgages can also be sold to savings banks, usually without HUD approval, with sales proceeds available to redeem bonds. FHA-insured issues during the high interest rate era which included a financing adjustment factor to raise allowable mortgage rates also incorporated provisions in indentures for refundings. It should be noted that if the multifamily project is publicly-owned (like all non-Section 8 programs), the possible incentives for prepayments are nonextant. Also, as seen elsewhere, state agencies often have much latitude with the disposition of principal recoveries. Each issue must be analyzed on a case-by-case basis, however, because certain "stand-alone" projects receive virtually no support from the state agency which may be the nominal issuer of the bonds.

Surpluses: Operating surpluses in these types of projects are rarely significant. Projected coverages of 1.10x debt service, including reserve fund earnings, are considered high. Much of the surpluses can be funnelled out of the indenture to the private owner or the housing authority. Again, state agency issues with open indentures may experience many fewer redemptions. Greater surpluses are sometimes seen as a result of excess construction note interest earnings which are transferred to bond accounts after final endorsement in FHA-insured deals.[8] This money could be used to redeem bonds, or as a reserve held by trustees or may be taken outside the deal. Surplus redemptions are also mitigated by the practice of releasing letters-of-credit or owner deposits, put up to fund required reserves, when funds on-hand are sufficient.

Other redemptions: Multifamily bonds contain provisions for partial or total redemption from proceeds of casualty insurance and condemnation awards, if not used to restore the property. Most issues allow a total redemption if the trustee has sufficient funds on-hand, including the debt service reserve, to redeem all outstanding bonds late in the life of the issue. Certain reserves based on percentages of outstanding debt are incrementally reduced and used for bond calls. Again, state agencies may have the flexibility to reuse these monies. Collateralized issues generally have provisions for mandatory redemptions if the value of the collateral falls below designated levels. GNMA-collateralized issues usually have redemptions from prepayments on GNMAs, which can be significant. Letter-of-credit backed issues often have mandatory redemptions if the LOC is not renewed continually. Cross-default provisions may exist in issues secured by multiple multifamily mortgages, whereby a default on one mortgage triggers a mandatory redemption of all bonds. Some state agency multifamily issues that are tax-exempt under Sections 103(b) and (c) may be refunded, subject to state laws and agency programs. Of course, term bonds are also subject to a mandatory sinking fund.

Redemption features

Prioritized calls: Assessing the priorities of bond maturities within an issue in the event of a partial call is an important aspect in determining the probability of a premature redemption. Housing bonds commonly attempt to deal with the prepayment problem and surpluses by funnelling these funds into certain maturities called "super-sinkers." Those maturities are sold to investors who prefer prepayments, causing the remaining bonds to be less vulnerable to calls.

Conversely, some maturities (often compound interest bonds), for marketing reasons, are the last called. The same bonds, for other kinds of partial redemptions, such as nonorigination or insurance proceeds, are usually subject to "strip calling," (i.e., *pro rata* redemptions) among bonds of all maturities. If this is not present, the danger exists that the reduced, level mortgage payment stream securing the bonds would be mismatched with a

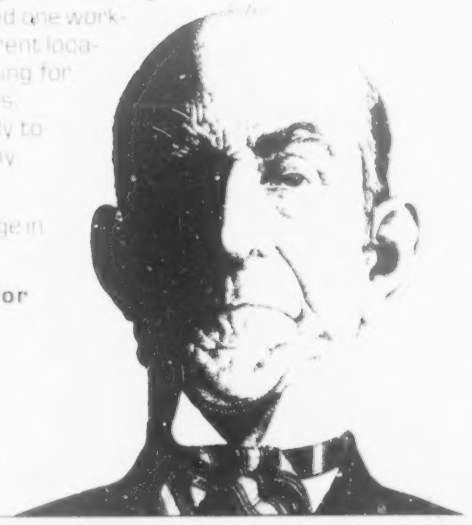
Complete Control of My Loan Processing and Servicing on My Budget?

Bah, Humbug!

It's true, Ebeneezer, it's true! You don't have to wait for the Ghost of Systems Future to show you the computer system of your dreams. Sulcus has your easy-to-learn, easy-to-use Loan Processing, Closing, Servicing, and Tracking system, whether you need one workstation or dozens in different locations. If you've been looking for something special, call us. We probably have it ready to go, and it's all pinchpenny affordable.

For the little bit of Scrooge in all of us.

Call 800-245-7900 for more information.



SULCUS

Sulcus Computer Corp.
41 North Main Street
Greensburg, PA 15601

MANUFACTURED HOUSING SPECIALISTS
We Purchase: Mobile Home & Land Combination Loans

We Offer:

- 48 Hour Loan Approval
- Loan by Loan or Bulk Purchases
- 45 Day Rate Locks
- Nationwide Service
- Conforming, Semi-conforming & Non-conforming Product
- National Loan Correspondent Program

800-826-6797 CA 714-781-2920

RESIDENTIAL MORTGAGE CORPORATION
Investment Mortgage Banking
An AMERICAN MORTGAGE SECURITIES Co.
3403 10th St., 7th Floor, Riverside, CA 92501

Your Loan Servicing:
When Thinking "Sale" Look for our Sails

With a servicing portfolio of over $7 billion, Fleet Mortgage Corp. (formerly "Mortgage Associates") is one of the five largest mortgage banking organizations in the nation. Savings and Loans, banks and other mortgage bankers are increasingly looking to our Correspondent Program, in particular, to eliminate the risk from their loan inventory. In the past two years, in fact, we've purchased in excess of $3 billion.

We provide pipeline protection of up to two months on current rates of FHA/VA and GPM loans. In addition, we offer multiple FHA/VA rates, accept buydowns, and purchase below market rate 15-year government loans. In every instance, you'll get the maximum price for your servicing. And we pay quickly. Further, we streamline the documentation process, making it as simple as possible.

Whether you're considering the sale of your current production or a portion or all of your portfolio—**one** loan or 100—consider Fleet Mortgage Corp. Our experience, resources and know-how make us good people to know. Give us a call and find out why more and more institutions are setting sail with the Fleet.

Contact Jim Loving (414) 291-8227

Fleet Mortgage Corp. A member of the Fleet Financial Group
125 E. Wells Street • Milwaukee, WI 53202 MA-3R1

lumpy debt service schedule. Mortgage payments may then be too low in some years to cover debt service. The effects of priority calls from prepayments in single-family bonds are, therefore, necessary to analyze in cash flow projections under various scenarios to ensure that the bonds will be paid off.

The variable factors in the cash flow runs are delivery rate, prepayment rate and lag in receipts of payments by trustee. A "super-sinker" run, for example, will burn out the super-sinker at a three-year average life rate, then revert to zero prepayments for the remaining life of the bonds. A call protected CAB (capital appreciation bond) run conversely, assumes rapid prepayment of all other maturities and then reverts to zero for the CABs. In multifamily issues also, the indenture should require that bonds may be priority-called only to the extent that it does not impair ability to pay debt service. Even surplus monies from interest earnings may be needed to pay debt service in future years. Most of the time, a priority call works best when the super-sinker or call-protected maturities are not a large percentage of the total issue.

Other features: Minimum call restrictions (ranging usually from $25,000 to $250,000) may have an impact on timing of calls. Bonds should be chosen by lot even among the various bonds in different maturity classes. Some state agencies have at their discretion the ability to call bonds with the highest coupons. Bonds may also be subject to the senior or subordinated lien of another issue (usually concurrently sold) which may prioritize certain types of redemptions. □

[1] Section 103(A) of the Internal Revenue Code specifically exempts excess arbitrage earnings on mortgage acquisition funds for only one year (five years for targeted areas). There is no explicit limit on the origination periods. However, if issues can be served by outside contributions or within the permanent arbitrage restrictions. One exception is specific Puerto Rican housing issues, which were exempt from the arbitrage regulations prior to 1984 and have five year origination periods as well as additional extensions.

[2] Given optional (buyers) statistics on seasoned discount FHLMC and FNMA pools. FHA regional prepayment records are not regularly published.

[3] It has been estimated that the average lives of mortgages can vary by 15 percent between different percentage runs of 100 FHA and 150 or 165 FHA.

[4] HUD researchers believe that actual dates from the years 1967-1981 were inaccurate.

[5] A very small number of multifamily bonds are secured by mortgages with private insurance companies, such as TICOR. Provisions of these issues may vary case by case.

[6] Through April 30, 1984 from HUD. Noncash terminations excluded, of course.

[7] Some examples of regulations imposed by Section 11(b) and via the Section 8 contract are: trustee possession of all revenues, requisitioning of trustee for operating expense, surpluses trapped in debt service reserve (limiting to HUD certain required insurance policies).

[8] This occurs in the FHA bonds issued concurrently with FHA notes, which is very common for construction financing.

WHAT THE PRESIDENT'S TAX PROPOSAL MEANS TO REAL ESTATE

In June 1985, the United States Department of the Treasury announced its second plan for tax simplification and reform. The plan is commonly referred to as Treasury II or the President's tax proposal.

If the proposal were to become law, the key questions of interest to the real estate community are: • What would be the impact on the cost of homeownership? • How would the proposed changes affect investment properties? • What would happen to property values?

In order to assess the impact of the President's tax proposal on the real estate industry, the various provisions were separated into those affecting owner occupants and those affecting real estate investors.

Owner occupants

The tax treatment of owner-occupants under Treasury I and the President's proposal is virtually identical. The only differences are in the definitions of the tax brackets and size of the zero bracket amount. As with the original tax proposal, three key provisions of the President's proposal will increase the cost of homeownership.

Loss of property tax deduction—The loss of property tax deductions on federal income taxes would directly raise the after-tax cost of homeownership. In states like California where house prices and property taxes are higher than average, this provision would be particularly painful and could depress house sales and prices in the short run.

Reduction of marginal tax brackets—Because the President's Proposal would reduce the number of tax brackets, many homeowners would fall into a lower tax bracket. Consequently, even though their mortgage interest payments would still be deductible, the value of the deduction for these owners would be less, resulting in an increase in homeownership costs.

Doubling of the personal exemption—The personal exemption would be increased in 1986 from $1,080 to $2,000. Again, while this does not directly affect ownership costs or house prices, the increase would effectively reduce the value of the mortgage interest deduction and help raise the after tax cost of owning a home.

Real estate investors

The President's Tax Proposal treats investors much less severely than Treasury I. The most onerous provisions in Treasury I have been removed, and other provisions that would increase the cost of owning investment real estate have been softened.

Replace ACRS with CCRS—Under the current Accelerated Cost Recovery Depreciation System (ACRS), property is depreciated over an 18-year period. For residential property, an accelerated system of depreciation is permitted. An owner can deduct 175 percent of the amount allowed using straight line depreciation rules resulting in depreciation in earlier years being greater than in later years. For instance, on a $100,000 property, the value of the first year depreciation is $100,000/18 × 1.75, or roughly $9,700. In subsequent years, the approximate value of the depreciation is $9,000, $8,000, and so forth.

The President's proposal will replace ACRS with the Capital Cost Recovery System (CCRS). The essence of this change is two-fold. First, the useful life of the property would be extended from 18 to 28 years. Second, the cost basis of the structure would be indexed for inflation. Consequently, the proposal would push depreciation deductions into the future, reversing the current system of larger deductions in early years. However, unlike ACRS, during periods of rapid inflation, depreciation allowances would increase over time. Because of this, property owners would gain greater income during the holding period through the increased depreciation allowance. This, in turn, would help offset rent increases.

In addition, the President's proposal would revise the way costs incurred during construction are recovered. Currently, interest costs and taxes paid during construction are amortized at 10 percent annually. The President's proposal would require the investor to include these costs in the depreciable basis of the property, thus extending the recovery period from 10 years to 28 years.

Revised capital gains treatment of real estate—Presently, the top capi-

By Michael S. Salkin and Michael Smith-Heimer

tal gains tax rate is 20 percent. The President's proposal would reduce the rate to 17.5 percent. However, depreciable assets, including real estate, would not be eligible for the capital gains tax rate. Instead, the gain from the sale of a building would be adjusted for inflation and essentially taxed at ordinary tax rates.

One advantage of this method is that the tax on the sale of a property exclusive of land would be due only if the asset increases in value in excess of the rate of inflation. If the value of the building increases at the rate of inflation or below it, then the inflation-indexed value of the property would equal or exceed the sales price, creating a loss for tax purposes at the time of sale.

Eliminate favorable tax treatment of residential real estate—Under current law, residential investment property is given special attention. ACRS permits an accelerated rate of depreciation. When a residential investment property is sold, the taxpayer must report the portion of the depreciation allowance claimed during the holding period that exceeds straight line depreciation as ordinary income. This permits the owner of the property to use the income from the "excess" depreciation for the holding period, gaining use of the money for a number of years.

Under the terms of the President's proposal, the preferential position given residential real estate would be eliminated. Because all property owners must utilize the same depreciation methods, the relative after-tax value of residential real estate will decline, dampening investment in residential properties.

Limit deductibility of interest costs—Current law divides interest costs into three categories. *Consumer* interest on automobiles, vacation homes, boats, etc. and *business* interest from the operation of a business are fully deductible. *Investment* interest, however, is not fully deductible. It is limited to $10,000 in excess of the investment income received by the taxpayer.

The President's proposal would limit the deductibility of interest costs. The limitation will be enacted in two phases. During the first phase, the $10,000 cap on investment interest would be reduced to $5,000. This would occur before 1988.

During the second phase, the interest limitation would be expanded to include consumer interest and limited partnership interest. All consumer interest, with the exception of interest on the taxpayer's principal residence, would be subject to the $5,000 cap. Interest costs from a limited real estate partnership, where the taxpayer is a limited partner, also would fall into the expanded definition of investment interest.

The treatment of consumer and limited partnership interest costs as investment interest subject to the cap would be phased in over a 10-year period at an increase of 10 percentage points per year. For example, in taxable years beginning in 1986, 10 percent of consumer and limited partnership interest costs would be subject to the limitation. In 1987, 20 percent of the investment interest would be subject to the limitation. In each subsequent taxable year, the percentage would be increased by 10 percentage points until the change was fully phased in.

Extend the "at-risk" limitation on business losses to real estate—If a real estate loan is secured only by the property with the lender having no recourse for the loan value through the personal assets of the borrower, the losses claimed for tax purposes on the investment can equal the value of the

Table 1

Impact of President's Tax Proposal on After Tax Cost of Occupancy

	Gross Income*	After tax cost of occupancy under: Current Tax Law	After tax cost of occupancy under: President's Proposal	Additional After Tax Cost	Decline in Home Value**	Percentage Decline in Home Value
$85,000 house						
Single	$32,238	$10,544	$11,582	$1,038	$ 8,797	−10.3%
Married couple	32,238	11,395	12,340	945	8,009	−9.4
Married couple Two children	32,238	11,488	12,340	851	7,215	−8.5
$115,000 house						
Single	43,616	13,466	15,414	1,948	16,505	−14.4
Married couple	43,616	14,454	15,689	1,235	10,462	9.1
Married couple Two children	43,616	14,610	15,792	1,182	10,014	−8.7
$250,000 house						
Single	94,817	25,945	30,351	4,406	37,338	14.9
Married couple	94,817	27,532	30,851	3,319	28,124	11.2
Married couple Two children	94,817	27,628	31,251	3,623	30,703	12.3

* The above figures represent the effective taxpayers' Adjusted Gross Income. Actual taxes may not be exactly as shown.
** The decline in property value occurs from capitalizing the additional yearly after tax expenditure over the life of the property.

property. This is allowed even though the investor only has "at-risk" the down payment and income generated by the property. Current regulations state that real estate loans do not need to meet at-risk requirements. However, under the President's proposal, if the at-risk requirements are not met, losses would be limited to the equity and income earned from the property.

Due to existing law, it is not clear whether residential property in California of four units or less can meet the at-risk requirements. This will severely limit the amount of financial exposure homeowners can be legally subjected to by lenders. The Treasury acknowledges that there are potential legal problems with the proposal and recommends that states amend existing legislation to address the legal road blocks.

One of the major reasons the demand for real estate has been so large in recent years is that investors have not been subjected to at-risk limitations. Consequently, the ability to post taxable losses in excess of the amount of capital tied up in the project has added value to the project.

Financial impact on owner-occupants

The President's proposal would cause the after-tax cost of homeownership to rise, but total income tax paid would decline, resulting in an increase in disposable income. Property values would decline 10 percent, at most, depending on the value of the house and the degree to which the increase in costs are capitalized into prices.

This conclusion is based on a comparative tax analysis of three house purchases with values of $85,000, $115,000, and $250,000. It was assumed that each owner spent 28 percent of their gross income on principal and interest payments. It also was assumed that the taxpayer had no other deductions and that the house was the only investment present. In addition, calculations were made based on occupancy of each house by a single person, a childless couple, and a family of four.

As shown in Table 1, in all cases the combined effect of the loss of property tax deduction, increase in zero bracket amount and reduction in marginal tax rates by the President's proposal would raise the after-tax costs of homeownership.

For example, to the family of four living in a $85,000 house (the median price in the U.S.), the costs of owning a house would increase 7.4 percent or $851 per year. For the $115,000 house (the median price in California), the same family would incur a cost increase of 8.1 percent or $1,182 annually.

> "Although the top tax rate drops to 38 percent, the rate brackets for most middle income Americans fall relatively little."

The increased homeowner costs were partially offset by a rise in disposable income. In the absence of the other provisions of the President's proposal, revised marginal tax rates generally decreased the level of tax paid. For instance, disposable income increased by about $196 or 0.7 percent for the owner of the $85,000 house, and $618 or 1.6 percent for the owner of the $115,000 house. The reduction in tax obligation is due to the doubling of personal exemptions, the lower taxable income and the taxing of income at substantially lower rates. Table 2 highlights changes in the taxes owed by various taxpayers and the resulting increases in disposable income.

Because the costs of ownership would increase under the President's proposal, property values would potentially fall. The decline would depend on the extent to which costs are capitalized into house prices. If 100 percent capitalization was assumed—an extremely high rate—then the $85,000 house occupied by the family of four would decline in value $7,215 or 8.5 percent, the $115,000 house would drop in value $10,014 or 8.7 percent, and the $250,000 house would fall in value $30,703 or 12.3 percent. In all cases a discount rate of 12 percent was assumed. This rate reflects the "opportunity cost" of carrying debt on 80 percent of the property combined with the return the taxpayer would expect, if instead of buying a house, the down payment was placed in a safe investment.

If 100 percent capitalization does not occur (the most likely event), then values would decline less. In addition, the change in property value depends on overall levels of demand, and on how owners spend the increase in disposable income gained from the lower tax bite. The demand for housing may actually increase because, relative to all other investments, the tax advantages of homeownership may still be superior. If this situation emerges, the demand for housing will rise and property values will increase. In fact, it is possible that the demand for large expensive houses would increase the most because equity in these houses can be used for a variety of other purchases.

Given that the longer-term effects are impossible to predict, it is safe to conclude that in the short run the rising after-tax costs of homeownership will lead to some reduction in property values. However, the decline will likely to be very small and short lived for homeowners living in median-priced houses. As the demand for expensive houses increases, house prices are likely to rise.

Financial impact on real estate investors

Property values could decline approximately 10 percent as a result of the changes in the tax laws governing investment property. Construction of rental units would drop and rents would eventually rise to offset the increased operating costs.

To arrive at these conclusions, an

Michael S. Salkin is vice president, senior economist and head of California Economic & Financial Research, Bank of America in San Francisco.

Michael Smith-Heimer is senior financial consultant, mortgage banking, Bank of America.

analysis was undertaken of the construction, operation and ultimate sale of a 12 unit apartment building. Assumptions were made regarding construction costs, rents, land costs, site improvements, etc. The rate of inflation during the holding period was assumed to average 6 percent. Estimations of after-tax cash flows, after-tax return on equity (ROE), and internal rates of return (IRRs) were made for both current tax law and the President's proposal.

Under the President's proposal, annual after-tax cash flows achieved from holding the property remained positive throughout the holding period but were generally below after-tax cash flows under current law. Not until the 10th year of the project-life did the annual cash flow exceed that achieved under current tax law.

The proposed change from the Accelerated Cost Recovery Depreciation System to the Capital Cost Recovery System would cause the majority of the cash flow reductions. For example, assuming the building were constructed at a cost of $664,000, held for 15 years, and sold for $1.5 million, the net present value of the tax savings achieved from depreciation expenditures would decline from $132,739 under current law to $71,570. As a result of this reduction, a modest 10 percent decline in the value of the project would occur.

"From all appearances, it looks as though tax reform as applied to real estate is an attempt to turn the clock back and return to the tax laws that existed prior to 1981."

The President's proposal does offer investors an advantage when the property is sold, however. Indexing the property basis to inflation reduces the taxable gain at time of sale. The reductions in the after-tax cash flows are offset by the lower tax paid under the President's proposal as opposed to current law. In the example cited, the after-tax cash from a sale based on the President's proposal exceeded current tax law by nearly $75,000 if the property is sold in the third year, and this differential continues to increase throughout the first 15 years. In the 15th year, the after-tax cash received from the property would exceed current law by $315,000.

The relative value of the investment depends on the amount of equity contributed to project development. Four separate equity levels were examined, ranging from an all-equity project down to a 10 percent equity project. Figure 1 shows the relative project returns based on this range of equity levels.

At equity levels below 50 percent, the President's proposal induces slightly inferior internal rates of return. However, at equity levels above 50 percent, the President's proposal offers marginally higher investment results. If the project is financed through 100 percent equity, the President's proposal offers IRRs up to 10 percent greater than rates under current law.

The after-tax return on equity for the project reveals a similar pattern. In general, during the first nine years the current tax law provides a greater return on investment. While an all-equity project performs significantly better under the President's proposal, the

Table 2

Impact of President's Tax Proposal on After Tax Disposable Income

	Gross Income*	Income tax under: Current Tax Law	Income tax under: President's Proposal	Increase (Decrease) in Disposable Income	Percentage Increase (Decrease) in Disposable Income
$85,000 house					
Single	$32,238	$ 3,664	$ 3,842	$(178)	(0.6)%
Married couple	32,238	2,953	2,911	42	0.1
Married couple Two children	32,238	2,507	2,311	196	0.7
$115,000 house					
Single	43,616	5,648	5,908	(260)	(0.7)
Married couple	43,616	4,696	4,418	278	0.7
Married couple Two children	43,616	4,139	3,521	618	1.6
$250,000 house					
Single	94,817	17,927	17,978	(51)	(0.1)
Married couple	94,817	15,449	13,713	1,736	2.2
Married couple Two children	94,817	14,591	12,713	1,878	2.3

*The above figures represent the effect on taxpayers with only homeowner deductions. Assumes principal and interest payments are equal to 28 percent of gross income. Gross income is derived from monthly payments. Figures may not be exact due to rounding.

"In all likelihood, if real estate tax reform occurs at all, the real estate industry will lose precisely what it gained as a result of the 1981 Economic Recovery Tax Act."

ROE still remains below current levels during the first seven years.

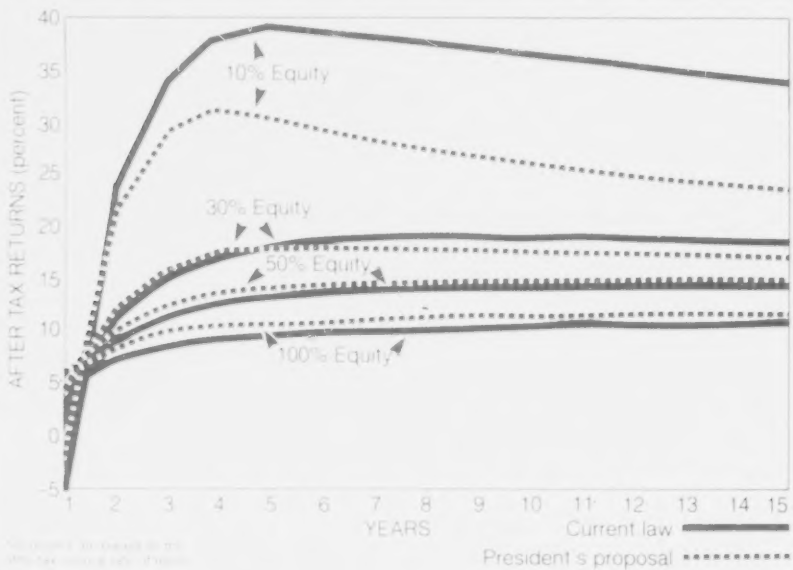
These measures reveal the important trend of the President's proposal. The payback period for residential construction will be lengthened significantly and the relative value of an apartment development will decrease during the early project life. Moreover, unless equity levels are greater than 50 percent, the relative investment return will decrease under the President's proposal.

Calculating the net effect of the President's proposal on investor property is more difficult. As the discussion above indicates, much depends on the way the property is financed, the level of equity contributed to the project and the expected holding period of the property. Because the project value under the President's proposal is dependent on both longer holding periods and the ultimate sale, the holding pattern of real estate will change dramatically. Property must be held longer because the depreciation schedules are greater in later years. The property must be sold because only after the sale will IRRs earned from the project equal IRRs earned under current law. However, the loss of cash flow during the holding period will tend to depress property values. If the full reduction in cash value were capitalized into the value of the property, the value of the building would decline about 10 percent, assuming a 15 percent discount rate.

Moreover, because the value of cash flow losses is recovered at the time of sale, owners may be motivated to sell buildings earlier, in order to "cash out" equity. Thus, while tax reform was designed, in part, to reduce the "churning" of property, the increased value in property equity may counter the advantages of property indexation. Therefore, it is not clear whether the

Figure 1

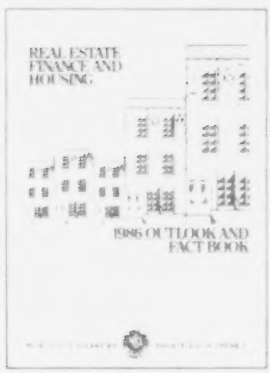
Comparison of after tax returns* (President's proposal v. current law)



TURN TO THE TABLES . . .

MBA's Newly Published Statistical Tables on Housing & Financial Markets

Real Estate Finance and Housing 1986 Outlook & Fact Book



A reference that is:

Convenient – Nearly 200 tables specifically gathered for CEOs and division managers who need to know about • Housing • Interest Rates • Mortgage Market Activity.

Relevant – *A barometer* on the current economic environment with an outlook for 1986, prepared and supervised by MBA Chief Economist Lyle E. Gramley; *an overview* of financial markets and housing industry activity during 1985; and *an analysis* of trends in inflation, Federal Reserve policy, housing and mortgage lending.

Member price $8 **Nonmembers** $12

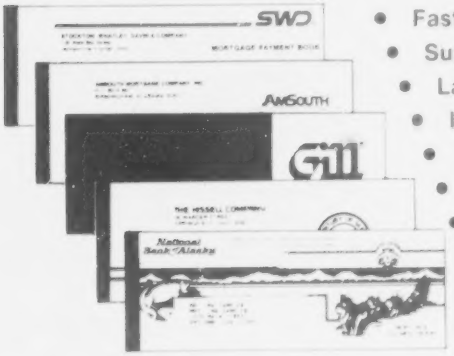
Quantity discounts: Members $6 Nonmembers $9 (5 or more) 10% shipping/handling charges and 6% for D.C. residents applies.

To order: Please enclose your check with a letter stating your name and order, the amount enclosed, company name, full address information (include shipping address) and phone number to **Mortgage Bankers Association of America, P.O. Box 37236, Washington, D.C. 20013.**

PAYMENT BOOKS A PROBLEM?

Call

THE PAYMENT BOOK SPECIALISTS



- Fastest Turn-Around
- Superior Service
- Laser Print Technology
- Immediate Response
- Highest Quality
- Price Guarantee
- Performance Guarantee
- Data Transmission
- Account Attention
- In-House Graphics

NATIONAL COMPUTER PRINT, INC.
5200 East Lake Boulevard
Post Office Box 97
Birmingham, Alabama 35201-0097
Gary Aderhold - Sr. Vice President/Sales
Phone: 205/849-5200

WE ARE THE INDUSTRY'S STANDARD OF EXCELLENCE

CALL OUR CORPORATE HEADQUARTERS FOR THE ACCOUNT EXECUTIVE IN YOUR AREA

$7,625,000

WINDERMERE MANOR
Jacksonville, Florida
Rental Housing for the Elderly
developed by
Windermere Associates, Ltd.

The undersigned arranged the financing
of this retirement service center
with HUD 221(d)(4) coinsurance

ABG FINANCIAL SERVICES, INC.
Mortgage Bankers &
HUD Coinsuring Lenders

300 E. Lombard Street
Suite 1100
Baltimore, MD 21202

provisions in the President's proposal will eliminate tax-motivated property sales.

The President's proposal will reduce the value of both owner-occupied and residential investment property, although much less so than in the original Treasury proposal. For homeowners, disposable income will increase and minimal declines in property values will occur. Moreover, the relative position of housing as an investment will remain high, further moderating potential declines in value.

An update

Recently a proposed tax bill passed the House of Representatives and another is expected to clear the Senate late in 1986. The tax treatment of owner occupants under the House bill and Treasury II is virtually identical with two exceptions. First, the House bill allows the deductibility of state and local taxes and the deduction of mortgage interest on second homes. Second, tax rates under the House bill fall far less than under Treasury II. Although the top tax rate drops to 38 percent, the rate brackets for most middle income Americans fall relatively little. In total, it appears that homeowners would fare better under the provisions of the House bill.

In general, the House bill treats investors less severely than Treasury II. First, CCRS in Treasury II would be replaced with indexed straight line depreciation over a 30-year period in the House bill. Second, the limitation on interest deductions proposed in Treasury II would be relaxed. Deductions for nonbusiness interest would be increased from $5,000 as proposed in Treasury II to $20,000 plus investment income.

From all appearances, it looks as though tax reform as applied to real estate is an attempt to turn the clock back and return to the tax laws that existed prior to 1981. The proposed changes in existing real estate tax law suggested in Treasury I are slowly but steadily being dropped or modified with each successive tax proposal. In all likelihood, if real estate tax reform occurs at all, the real estate industry will lose precisely what it gained as a result of the 1981 Economic Recovery Tax Act. Individual homeowners will remain relatively unaffected. □

MORTGAGE MARKET TRENDS

Lower interest rates, rising stock prices and lower world oil prices should provide the basis for 3 percent to 4 percent economic growth during 1986, a significant rise from the 2.4 percent rate reported for the fourth quarter. Interest rates should remain stable at current levels through mid-year.

Consumer spending can be expected to grow appreciably in the near-term. The increases of 834,000 in payroll employment over the November 1985 to January 1986 period, resulting in a drop in the civilian unemployment rate to 6.7 percent from the 7.0 percent recorded in October, adds significantly to purchasing power. Personal income shows signs of renewed strength, rising 1.4 percent in December. In addition, the bull market has resulted in a sharp increase in the value of stock and, in the process, consumer wealth. Finally, the Conference Board reports that consumer confidence remains high.

Business fixed investment increased markedly in the fourth quarter and will be strengthened in 1986 by today's relatively lower cost of capital. Inventory investment, with the exception of the automobile sector, should also increase. Both manufacturing and trade inventory to sales ratios have been edging down recently and are now lower than their recent trend levels.

The industrial sector shows signs of revival. Industrial production rose 0.3 percent in January, following increases of 0.7 percent and 0.6 percent, respectively in December and November. Capacity utilization has also shown an upward trend in recent months.

The continuing fall of the dollar should improve the net export sector in the near future. The dollar recently reached a seven-year low against the Japanese yen and has dropped substantially relative to the currencies of other major trading nations. The weaker dollar, together with the recent drop in oil prices, should stabilize the real volume of net exports in the first half. Moderate improvement in the nation's trade balance can be expected in the second half.

The rate of price increase should fall back into its moderate trend pattern in the very near future. After rising in the fourth quarter, largely due to increases in the price of food and fuel, both the producer price index and consumer price index appear headed toward their respective 1985 averages. Lower world oil prices have significantly improved the 1986 inflation outlook. During the course of the year, the inflation rate should be roughly equal to the 1985 record.

The Federal Reserve can be expected to maintain its current policy, shifting to a more accommodative stance if any fiscal restraints imposed by the Gramm-Rudman-Hollings Deficit Reduction Act warrant such a change. Thus resulting in stable rates at current levels through mid-year.

Low mortgage interest rates, a high level of housing affordability and steady economic growth should result in a continuation of the current strong housing market, especially in the first half.

Existing home sales in 1985 reached their highest level since 1979. New home sales also recorded impressive gains in recent months and stood at 721,000 in December at a seasonally adjusted annual rate. Even more impressive are the increases in both starts and permits, both of which stood at more than 1.8 million in December. Finally, the value of new construction put in place in 1985 was up 10 percent over the 1984 total.

Housing starts should total close to 1.8 million in 1986, with a particularly strong performance during the first half. Single-family originations should exceed $250 billion in dollar volume in 1986, after having recorded an estimated $230 billion in 1985.

Dr. Victor Cholewicki
Assistant Economist
February 18, 1986

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES, BY UNIT TYPE

(Units in thousands)

YEAR AND MONTH	HOUSING STARTS						PERMITS 17,000 ISSUING PLACES					
	Actual			Seasonally Adjusted Annual Rate			Actual			Seasonally Adjusted Annual Rate		
	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units
1985												
JUL	160	114	46	1,663	1,148	515	158	103	55	1,694	1,088	606
AUG	161	109	52	1,740	1,156	584	159	101	58	1,784	1,117	667
SEP	148	98	50	1,616	1,058	558	167	93	74	1,808	1,076	732
OCT	173	112	61	1,772	1,197	575	158	100	58	1,688	1,077	611
NOV	121	78	43	1,566	1,041	525	120	74	47	1,661	1,029	632
DEC$_P$	115	71	44	1,840	1,204	636	126	66	59	1,844	1,081	763
1983 TOTAL	1,703	1,181	522				1,605	1,035	570			
1984 TOTAL	1,750	1,206	544				1,682	1,065	617			
12 MONTHS												
1985	1,733	1,164	569				1,739	1,083	656			
1984	1,750	1,206	544				1,682	1,065	617			
1983	1,703	1,181	522				1,605	1,035	570			
1982	1,062	743	320				1,001	635	366			

RESIDENTIAL STRUCTURES BY REGION

(Units in thousands)

YEAR AND MONTH	STARTS								PERMITS 17,000 ISSUING PLACES							
	Actual				Seasonally Adjusted Annual Rate				Actual				Seasonally Adjusted Annual Rate			
	North East	Mid-West	South	West	North East	Mid-West	South	West	North East	Mid-West	South	West	North East	Mid-West	South	West
1985																
JUL	23	23	70	44	208	217	783	455	23	26	66	43	238	256	754	446
AUG	25	26	65	44	230	250	739	521	25	25	65	44	266	259	770	489
SEP	24	23	61	40	229	230	703	454	25	24	65	53	242	225	758	583
OCT	32	28	72	41	311	222	797	442	29	25	65	39	282	228	736	442
NOV	19	16	57	29	222	190	735	416	21	16	52	32	270	202	716	473
DEC$_P$	16	13	53	33	279	268	818	475	18	17	61	30	263	294	855	432
1983 TOTAL	168	218	935	382					164	188	863	390				
1984 TOTAL	204	243	866	436					201	212	812	457				
12 MONTHS																
1985	251	238	778	466					264	238	754	483				
1984	204	243	866	436					201	212	812	457				
1983	168	218	935	382					164	188	863	390				
1982	117	149	591	205					107	126	544	224				

HOUSING ACTIVITY (Cont'd.)

YEAR AND MONTH	HOUSING SALES (Units in thousands) EXISTING HOUSES[1]	NEW HOMES Sold	NEW HOMES Available For Sale	NEW HOMES Months Supply at Current Rate	VALUE OF NEW CONSTRUCTION PUT IN PLACE (Dollars in billions) Seasonally Adjusted Annual Rate Total	1 Unit	2+ Units	Non-res.	CONSTRUCTION STATUS (Units in thousands) Seasonally Adjusted Annual Rate Under Construction Total	1-4 Units	5+ Units	Completions Total	1-4 Units	5+ Units
1985														
JUL	311	63	351	5.8	$198.8	$83.4	$29.5	$85.9	1,073	636	437	146	100	46
AUG	337	61	351	6.0	201.4	84.0	29.4	88.0	1,084	642	442	154	103	51
SEP	281	54	352	6.5	203.4	84.1	29.7	89.6	1,063	624	439	158	110	48
OCT	301	52	358	6.6	234.4	85.3	60.4	88.7	1,089	633	456	151	110	41
NOV	246	49	358	6.2	204.7	85.6	29.3	89.8	1,082	626	456	143	100	43
DEC$_P$	**221**	**47**	**356**	**5.8**	**212.5**	**85.8**	**31.4**	**95.3**	**1,082**	**620**	**462**	**159**	**111**	**48**
1983 TOTAL	2,719	623										1,390	1,016	374
1984 TOTAL	2,868	639										1,652	1,137	515
12 MONTHS														
1985	3,216	686										1,700	1,167	533
1984	2,868	639										1,652	1,137	515
1983	2,719	623										1,390	1,016	374
1982	1,990	412										1,006	712	293

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Unit Type
(Dollars in millions)

YEAR AND MONTH	TOTAL Total	Mtg. Bankers[3]	S&Ls	Banks[2]	Life Cos	1-4 UNITS Total	Mtg. Bankers[3]	S&Ls	Banks[2]	Life Cos.
1985										
FEB	$20,961	$4,273	$ 7,941	$ 7,351	$1,396	$12,944	$3,717	$5,618	$3,555	$ 54
MAR	25,406	4,333	10,681	8,350	2,042	16,517	4,037	7,887	4,502	91
APR	26,120	4,849	11,955	7,403	1,913	17,909	4,467	9,178	4,208	56
MAY	28,212	4,548	13,096	8,519	2,049	19,602	4,377	10,268	4,897	60
JUN	32,571	5,423	12,665	12,370	2,113	20,945	5,080	9,551	6,232	82
JUL$_P$	**30,932**	**6,028**	**11,709**	**11,051**	**2,144**	**20,959**	**5,655**	**9,093**	**6,110**	**101**
1983 TOTAL	276,371	65,050	103,882	91,500	15,939	193,535	55,680	81,524	55,605	726
1984 TOTAL	297,406	53,160	129,482	97,776	16,988	196,139	44,500	96,187	54,626	826
7 MONTHS										
1985	184,388	33,458	75,969	62,370	12,591	122,467	31,227	57,317	33,431	492
1984	175,871	33,330	77,815	55,992	8,734	123,189	31,187	59,205	32,322	475
1983	149,110	37,568	54,919	49,701	6,922	110,261	35,547	43,619	30,674	421
1982	67,238	14,857	21,931	25,749	4,701	45,997	13,406	18,001	14,302	288

LENDER ACTIVITY (Cont'd.)

LOANS CLOSED (Cont'd.)

(Dollars in millions)

YEAR AND MONTH	5+ UNITS					NONRESIDENTIAL				
	Total	Mtg. Bankers[9]	S&Ls	Banks[2]	Life Cos.	Total	Mtg. Bankers[9]	S&Ls	Banks[2]	Life Cos.
1985										
FEB	$1,830	$378	$ 923	$396	$133	$6,187	$178	$1,400	$3,400	$1,209
MAR	2,020	170	1,162	511	177	6,869	126	1,632	3,337	1,774
APR	1,937	163	1,223	406	145	6,274	219	1,554	2,789	1,712
MAY	1,992	34	1,238	505	215	6,618	137	1,590	3,117	1,774
JUN	2,329	228	1,417	590	94	9,297	115	1,697	5,548	1,937
JUL[P]	**1,770**	**19**	**974**	**604**	**173**	**8,203**	**354**	**1,642**	**4,337**	**1,870**
1983 TOTAL	19,443	3,840	8,521	5,485	1,597	63,393	5,530	13,837	30,410	13,616
1984 TOTAL	22,125	1,980	13,160	5,519	1,466	79,142	6,680	20,135	37,631	14,696
7 MONTHS										
1985	13,108	1,028	7,628	3,413	1,039	48,813	1,203	11,024	25,526	11,060
1984	12,039	348	7,390	3,514	787	40,643	1,795	11,220	20,156	7,472
1983	8,225	425	4,469	2,792	539	30,624	1,596	6,831	16,235	5,962
1982	3,413	550	1,438	1,148	277	17,828	901	2,492	10,299	4,136

LONG-TERM COMMITMENT ACTIVITY

By Type of Institution

(Dollars in millions)

YEAR AND MONTH	ISSUED DURING MONTH					OUTSTANDING				
	Total	Mtg. Bankers[9]	S&Ls	Banks[2]	Life Cos.	Total	Mtg. Bankers[9]	S&Ls	Banks[2]	Life Cos.
1985										
FEB	$20,485	$3,695	$10,564	$3,624	$2,602	$ 92,165	$ 8,987	$50,899	$16,994	$15,285
MAR	28,222	3,404	14,217	7,831	2,770	98,340	8,921	53,175	21,748	14,496
APR	24,853	3,897	14,893	3,758	2,265	97,905	10,616	55,146	15,865	16,278
MAY	25,999	4,355	15,100	4,115	2,429	98,643	10,108	55,898	16,223	16,414
JUN	27,516	5,156	14,174	5,385	2,801	103,639	11,401	56,079	19,126	17,033
JUL[P]	**26,393**	**4,288**	**14,594**	**4,928**	**2,583**	**95,189**	**10,167**	**49,838**	**17,882**	**17,302**
1983 TOTAL	260,343	81,070	123,361	38,195	17,717					
1984 TOTAL	264,193	50,100	146,184	47,065	20,844					
7 MONTHS										
1985	171,014	27,593	92,749	33,233	17,439					
1984	162,382	29,098	91,017	29,886	12,381					
1983	146,079	43,645	70,116	21,581	10,737					
1982	56,091	19,011	22,326	10,984	3,770					

MORTGAGE INSURANCE

(Units in thousands. Dollars in millions)

YEAR AND MONTH	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	Total	FHA[3]	VA	Private	Total		FHA(203)		VA		Private	
					Units	Amt.	Units	Amt.	Units	Amt.	Units	Amt.
1985												
JUL	218	93	24	101	96	$6,558	11	$ 656	16	$1,104	69	$4,798
AUG	216	88	25	103	114	7,646	28	1,644	19	1,275	67	4,727
SEP	201	82	26	93	130	8,545	47	2,771	20	1,318	63	4,456
OCT	205	84	24	97	122	8,308	34	2,041	16	1,120	72	5,147
NOV	173	78	27	68	128	8,488	47	2,795	25	1,693	56	4,000
DEC[P]	**163**	**80**	**22**	**61**	**93**	**6,319**	**23**	**1,359**	**19**	**1,347**	**51**	**3,613**
1983 TOTAL	1,921	777	261	883	1,305	79,470	367	19,141	286	17,966	652	42,363
1984 TOTAL	1,862	477	180	1,205	1,344	86,775	200	10,644	198	12,728	946	63,403
12 MONTHS												
1985	2,194	902	251	1,041	1,261	83,305	338	19,784	192	13,046	731	50,475
1984	1,879	477	197	1,205	1,344	86,774	200	10,644	198	12,728	946	63,402
1983	1,993	777	333	883	1,305	79,470	367	19,141	286	17,966	652	42,363
1982	1,034	400	163	471	570	29,074	103	4,893	93	5,428	374	18,753

SECONDARY MARKET ACTIVITY

(Dollars in millions)

YEAR AND MONTH	FNMA Portfolio Comm	FNMA Portfolio Purc	FNMA Mortgage-Backed Securities Outstanding	FNMA Mortgage-Backed Securities Issued	FHLMC Comm. to Sell	FHLMC Comm. to Buy	FHLMC Mtg. Purc.	FHLMC Mtg. Sold	GNMA Pass-Through Securities Applications	GNMA Pass-Through Securities Issued
1985										
JUL	$1,583	$ 1,918	$43,891	$ 1,527	$ 2,714	$ 3,258	$ 4,626	$ 4,385	$ 9,086	3,859
AUG	1,797	1,921	45,668	2,207	3,855	3,958	3,602	2,685	5,872	4,153
SEP	1,638	1,739	48,769	3,654	2,757	2,919	4,219	4,501	6,927	4,403
OCT	1,733	1,767	50,363	2,228	4,169	3,995	3,215	3,081	6,849	5,795
NOV	1,199	1,624	52,198	2,469	5,394	4,854	3,681	3,449	6,059	5,251
DEC[p]	1,858	1,663	54,987	3,365	n.a.	n.a.	n.a.	n.a.	5,699	4,520
1983 TOTAL	18,607	17,553	—	13,340	30,921	32,846	22,952	21,376	70,280	50,496
1984 TOTAL	21,007	16,721	—	13,546	30,743	32,601	21,885	20,489	36,101	27,857
12 MONTHS										
1985	20,225	21,510	—	23,649	41,009*	43,337*	37,917*	35,119*	64,630	45,868
1984	21,006	16,721	—	13,546	26,968*	28,427*	17,747*	16,171*	36,101	27,857
1983	18,607	17,553	—	13,340	29,660*	31,143*	21,216*	20,256*	70,280	50,496
1982	22,106	15,113	—	13,969	27,287*	27,110*	19,755*	20,365*	38,865	16,012

INTEREST RATES AND YIELDS

YEAR AND MONTH	1- to 4-UNIT MORTGAGES: FHA OPINION SURVEY FHA NEW[2]	FHA OPINION SURVEY CONVENTIONAL New	FHA OPINION SURVEY CONVENTIONAL Existing	FHLBB SURVEY CONVENTIONAL New	FHLBB SURVEY CONVENTIONAL Existing	FNMA 1 Yr. ARM (1%/Yr.)	FNMA FRM Conv.	APARTMENTS[5]
1985								
SEP	12.04%	12.02%	12.03%	11.17%	11.20%	10.54%	11.775%	13.21%
OCT	11.87	11.86	11.88	11.09	11.32	10.50	11.575	13.03
NOV	11.28	11.56	11.58	11.01	11.26	10.26	11.160	12.38
DEC	10.70	11.03	11.03	10.94	11.12	9.94	10.425	12.06
1986								
JAN[p]	n.a.	n.a.	n.a.	10.89	10.81	10.00	10.375	12.00

CURRENT SECONDARY MARKET YIELDS

YEAR AND MONTH	GNMA[6]	FNMA[6]	FHLMC[6]
1985			
AUG	11.39%	11.38%	11.42%
SEP	11.41	11.43	11.47
OCT	11.24	11.28	11.34
NOV	10.96	10.95	11.01
DEC	n.a.	n.a.	n.a.
1986			
JAN[p]	n.a.	n.a.	n.a.

SELECTED SECURITIES

YEAR AND MONTH	A-Rated[7] Utility	U.S. Government 10-yr.	U.S. Government 26-wk.	Prime Comm. Paper 90-119 Days
1985				
AUG	11.77%	10.33%	7.32%	7.72%
SEP	11.87	10.37	7.27	7.83
OCT	11.82	10.24	7.33	7.80
NOV	11.38	9.78	7.30	7.77
DEC	10.91	9.26	7.14	7.75
1986				
JAN[p]	10.74	9.19	7.16	7.71

SPREADS (Basis Points)

YEAR AND MONTH	FHA New Minus A-Utility	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
1985				
JUL	35	95	99	96
AUG	22	106	105	109
SEP	17	104	106	110
OCT	49	100	104	110
NOV	(10)	118	117	123
DEC[p]	(21)	n.a.	n.a.	n.a.

n.a.—Not available. (p)—Preliminary.
[1] From the National Association of Realtors' "Existing Home Sales" series.
[2] Mutual Savings Banks and Commercial Banks.
[3] FHA applications received includes the Direct Endorsement Program starting in 1984.
[4] Secondary market gross yields.
[5] Federal Home Loan Mortgage Corp. Existing Construction only.
[6] Securities for 0 to 30 day delivery.
[7] Prior to January 1984 this rate was for Aaa-rated New Issue Utility Bonds.
[8] Year to date seasonally adjusted series not calculated.
[9] 1985 data on mortgage bankers obtained from the HUD Survey of Mortgage Lending Activity.
* — 11 Month Totals.

MORTGAGE BANKING ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED[1]

YEAR AND MONTH	NOT SEASONALLY ADJUSTED									SEASONALLY ADJUSTED			
		1-4 Units				5+ Units							
	Total	Total	FHA	VA	Conv.	Total	FHA	Conv.	Non-[3] res.	Total[2]	1-4 Units	5+ Units	Non-[3] res.
1984													
JUL	$ 3,760	$ 3,330	$ 800	$ 530	$ 2,000	$ 0	$ 0	$ 0	$ 430	$3,530	$2,960	$ 0	$460
AUG	3,570	3,070	520	380	2,170	0	0	0	500	3,120	2,600	0	510
SEP	3,050	2,400	550	380	1,470	70	70	0	580	3,380	2,500	120	780
OCT	3,700	3,110	820	470	1,820	0	0	0	590	3,600	2,920	0	750
NOV	3,370	3,090	820	470	1,800	0	0	0	280	3,890	3,610	0	280
DEC	5,250	4,090	1,280	690	2,120	80	0	80	1,080	4,880	3,860	70	770
1983 Total	65,050	55,680	20,620	12,570	22,490	3,840	810	3,030	5,530				
1984 Total	53,170	44,500	10,850	7,130	26,520	1,980	120	1,860	6,680				
12 MONTHS[5]													
1984	53,170	44,500	10,850	7,130	26,520	1,980	120	1,860	6,680				
1983	65,050	55,680	20,620	12,570	22,490	3,840	810	3,030	5,530				
1982	29,250	24,440	8,510	5,160	10,770	1,580	640	940	3,230				
1981	33,470	25,830	8,380	6,200	11,250	1,740	770	970	5,910				

COMMITMENT ACTIVITY: LONG-TERM MORTGAGE LOANS[1]

YEAR AND MONTH	COMMITMENTS DURING MONTH								OUTSTANDING COMMITMENTS END OF MONTH					
	To Borrowers				From Investors				To Borrowers			From Investors		
	Total	1-4 Units	5+ Units	Non-[3] res.	Total	1-4 Units	5+ Units	Non-[3] res.	1-4 Units	5+ Units	Non-[3] res.	1-4 Units	5+ Units	Non-[3] res.
1984														
JUL	$ 4,060	$ 2,940	$ 0	$1,120	$ 4,050	$ 3,580	$ 20	$ 450	$10,840	$ 70	$570	$9,870	$250	$1,570
AUG	2,920	2,630	0	290	4,220	3,380	10	830	7,430	40	500	7,730	210	1,600
SEP	2,910	2,640	30	240	2,760	2,400	80	280	7,350	300	500	7,460	480	800
OCT	3,910	3,240	0	670	4,550	4,090	30	430	7,660	170	540	8,400	370	740
NOV	3,430	2,820	0	610	3,880	2,760	170	950	7,460	40	690	6,940	270	1,050
DEC	5,480	4,090	430	960	4,850	3,910	80	860	7,850	100	750	7,810	260	1,170
1983 TOTAL	81,070	67,740	4,310	9,020	79,450	64,240	5,770	9,440						
1984 TOTAL	50,100	41,420	510	8,170	55,550	43,820	3,160	8,570						
12 MONTHS[5]														
1984	50,100	41,420	510	8,170	55,550	43,820	3,160	8,570						
1983	81,070	67,740	4,310	9,020	79,450	64,240	5,770	9,440						
1982	47,800	36,760	3,330	7,710	46,740	34,380	3,960	8,400						
1981	36,700	30,170	1,200	5,330	44,700	30,410	1,740	12,550						

OUTSTANDING END OF MONTH INVENTORY[1]

YEAR AND MONTH		1-4 Units				5+ Units			
	Total	Total	FHA	VA	Conv.	Total	FHA	Conv.	Non-res.[3]
1984									
JUL	$8,870	$6,990	$1,480	$1,090	$4,420	$730	$0	$730	$1,150
AUG	7,070	5,520	1,060	740	3,720	640	0	640	910
SEP	7,390	5,490	1,010	680	3,800	640	0	640	1,260
OCT	8,060	6,350	1,190	870	4,290	600	0	600	1,110
NOV	8,010	6,280	1,190	850	4,240	590	0	590	1,140
DEC	6,840	6,090	1,500	980	3,610	170	0	170	580

MORTGAGE BANKING ACTIVITY (Cont'd.)

YEAR AND MONTH	COVERAGE[4] 1-4 Units	5+ Units	Non-[3] res.	SERVICING VOLUME[1] Total	1-4 Units	5+ Units	Non-[3] res.	NOTES PAYABLE[1] (End of Month Balances) Total	Comm. Paper	To Banks	To Others
1984											
JUL	55%	31%	91%	$421,420	$317,600	$63,980	$39,840	$41,960	$6,190	$12,710	$23,060
AUG	60	31	113	363,570	282,400	42,060	39,110	47,940	5,750	13,220	28,970
SEP	58	51	45	381,070	302,840	39,300	38,930	59,220	4,520	14,240	40,460
OCT	60	48	45	417,780	339,960	40,660	37,160	57,230	4,830	17,070	35,330
NOV	51	43	57	422,490	350,580	39,790	32,120	54,180	4,820	19,180	30,180
DEC	**56**	**96**	**88**	**385,270**	**321,620**	**33,110**	**30,540**	**42,280**	**8,390**	**23,680**	**10,210**

CONSTRUCTION AND LAND LOAN ACTIVITY[1]

YEAR AND MONTH	CONSTRUCTION LOANS CLOSED Total	1-4 Units	5+ Units	Non-[3] res.	DISBURSEMENTS DURING MONTH Total	1-4 Units	5+ Units	Non-[3] res.	Land Loans	END OF MONTH INVENTORY Total	1-4 Units	5+ Units	Non-[3] res.	Land Loans
1984														
JUL	$790	$130	$210	$450	$280	$ 70	$10	$200	$180	$2,760	$ 900	$240	$1,620	$1,120
AUG	410	110	130	170	100	60	0	40	90	2,200	790	190	1,220	830
SEP	440	100	160	180	100	50	10	40	120	2,150	790	180	1,180	800
OCT	400	210	100	90	90	40	10	40	130	2,180	780	220	1,180	870
NOV	210	140	50	20	170	110	20	40	240	3,520	1,380	410	1,730	2,260
DEC	**470**	**270**	**120**	**80**	**430**	**220**	**30**	**180**	**470**	**9,240**	**3,790**	**790**	**4,660**	**3,440**

COMMITMENTS TO BORROWERS: AND LAND CONSTRUCTION LOANS[1]

YEAR AND MONTH	ISSUED DURING MONTH Total	1-4 Units	5+ Units	Non-[3] res.	END OF MONTH BALANCES Total	1-4 Units	5+ Units	Non-[3] res.
1984								
JUL	$1,730	$130	$ 60	$1,540	$4,090	$870	$470	$2,750
AUG	770	190	80	500	3,680	850	460	2,370
SEP	760	100	80	580	4,170	760	580	2,830
OCT	710	150	160	400	3,820	860	590	2,370
NOV	380	140	70	170	3,230	680	430	2,120
DEC	**790**	**200**	**10**	**580**	**3,910**	**930**	**280**	**2,700**

Notes: [1] All dollar amounts are in millions.

[2] Total is seasonally adjusted separately from components. Total, therefore, may not equal sum of parts.

[3] Series labeled non-residential are also inclusive of farm data.

[4] Percent coverage equals outstanding commitments received from investors divided by the sum of outstanding end of month inventory and outstanding commitments issued to borrowers, all multiplied by 100.

[5] Year-to-date seasonally adjusted series not calculated.